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SUBJECT: TAX PLAN APPROVED BY THE GOI

Classified By: William Weinstein for reasons 1.4 (b) and (d)

1. (C) Summary. The GOI approved a multi-year tax plan on June 5, prepared by the tax authority and the State Revenues Administration of the Ministry of Finance. The plan focuses on enabling Israel to become a more attractive and competitive location for investors while reducing income tax rates, particularly for lower wage earners. The plan envisions a range of cuts in personal income taxes, cuts in corporate taxes, a reduction in VAT, and unification of taxes on capital. The economic team responsible for drafting the tax plan stressed that it is designed to maintain the budget deficit targets and continue decreasing the public debt to GDP ratio. The Minister's Committee for Legislation is now preparing a draft bill, that is expected to be presented to the Knesset during the summer session. End Summary.

Corporate Taxation

2. (C) Among the details of the plan published on the Ministry of Finance website, corporate taxes will decline to 25% by 2010 according to the following schedule:

2006: 31%
2007: 29%
2008: 27%
2009: 26%
2010: 25%

The corporate tax rate outlined previously in the 2004 tax reform legislation was only scheduled to drop to 32% in 2006. The acceleration and extension of corporate tax reductions appears to be part of an effort by Minister of Finance Netanyahu to attract investors to establish new companies in Israel.

VAT Reduction

3. (U) The current VAT rate in Israel is 17%. The tax plan outlines a 0.5% reduction in VAT in 2005 to 16.5%, but does not provide a firm start date for the rate decrease. (Note: A reduction in the VAT rate alone does not require Knesset approval, but it is unclear if this proposal will be implemented before or in coordination with other tax law changes which require Knesset approval. End Note.) Then, pending positive economic developments in 2006, the VAT would be reduced by an additional 0.5% in 2007. The report estimates that every 1% reduction in VAT will increase state revenues by between two and a half to three Billion NIS (New Israeli Shekels) (approximately 600 million USD). The tax plan is a continuation of the Netanyahu policy of contributing to economic growth by reducing the tax burden on the public. The Finance Ministry maintains it will also bring in higher state tax revenues (from higher consumption).

Income Tax

4. (U) The income tax plan calls for reducing the highest marginal tax rate, currently set at 49% according to the following schedule:

2007: 48%
2008: 47%
2009: 46%
2010: 44%

Wage earners of 50,000 NIS or more/month will see their tax bill reduced from 43.8% of gross salary per month in 2005, to only 39.1 % in 2010. For those earning 10,000 NIS/month the tax bill will be reduced from 24.2% (2005) to 20.6% in 2010.

Capital

5. (U) A small portion of the cost of the tax plan will be financed by an increased tax rate on capital. Tax on capital

gains from the Tel Aviv Stock Exchange (TASE) and foreign stock exchanges will increase to 20% from the current rate of 15%. Tax on indexed deposits will increase to 20% from 15%. Tax on gains from bank deposits will increase to 15% from 10%.

Social Welfare

16. (U) The current tax plan includes a number of provisions targeted at vulnerable sectors including the unemployed, working mothers, the elderly and the disabled. The plan calls for:

-Special assistance to working mothers with low income to help cover the cost of day care;

-An incentive tax credit for someone who is unemployed who returns to work;

-An increase of NIS 110 (beginning in July 2005) to elderly people on a guaranteed income. Elderly couples will receive an additional 150 NIS/month.

-A decrease in the Bituach Leumi (national health insurance) tax for very low wage earners (those who earn less than 3,500 NIS/month)

In addition, during a June 5th meeting, the government decided that as part of the framework of the 2006 budget the Minister of Finance would present to the government a plan to introduce a negative income tax for low wage earners.

Costs of the Plan

17. (C) Michael Sarel, Deputy Director General for Macroeconomics, from the Ministry of Finance explained the cost of the tax plan as the difference between projected tax revenues if the plan is adopted, and the amount forecast to be collected if the tax rates remain the same. He cautioned however, that the entire plan projects costs in today's terms, and does not take into account changes in the behavior of investors and consumers due to market-risk changes. In part, these costs will be offset by the increase in capital gains taxes which is expected to bring in 400 million NIS. The tax plan extends over five years and is estimated to cost (in NIS):

2005: 400 million
2006: 2 billion
2007: 3.1 billion
2008: 5.7 billion
2009: 7.8 billion
2010: 11.2 billion

The jump in cost of the plan is a result of the decline in income tax revenues that would fall 4 billion NIS in 2008, 5.6 billion in 2009, and 8.1 billion in 2010. The costs do not take into consideration the increase in tax revenues that the government hopes will result from economic growth stimulated by the reduction in tax rates. The model used to develop the tax cuts assumes economic growth of about 3.9%, and real growth in expenditures of 1%. The plan's authors also note that if economic growth accelerates, it would be possible to accelerate the tax reduction.

Reaction

18. (U) Minister of Finance Netanyahu announced in an interview on Kol Israel on June 2, that the government is not planning further cuts in the 2006 budget as part of this plan. The Governor of the Bank of Israel, Stanley Fischer, supported the tax plan in testimony before the Finance Committee on May 30, and noted that it is important that the plan places emphasis on social welfare, while also reducing government debt and its high proportion of GDP. He told the local news media on June 2, that the changes that were made in the plan prior to the formal presentation are important because, "we dealt with the problems of poverty without adding large expenditures."

19. (U) Sever Plotsker, economic editor of Yediot Aharonot, wrote that the plan has good intentions, but "will not have a marginal effect on growth and economic activity in the next two years." Instead of tax cuts, Plotsker posits that massive investment in infrastructure is a better way to bolster economic growth in Israel.

10. (C) Gil Bufman, chief economist at Bank Leumi was less positive about the tax plan. In a conversation with Econoff, he criticized the plan as slightly regressive, as the highest tax cuts (as a percentage) are projected for the highest wage

earners. His main concern is that if the government passes tax cuts to be phased-in over five years, without a safety mechanism to stem cuts in the event of a setback in economic growth, the result will inevitably be an increase in deficit spending. Buffman wryly commented that this is further evidence of the importance that Netanyahu has placed on cutting taxes rather than decreasing the debt to GDP ratio. 11. (C) The tax plan will be introduced to the Knesset in the summer of 2005. Post will monitor and report on its likely impact on the GOI's budget deficit. The Loan Guarantee Agreement specifies this figure is to decrease 1/2% of GDP per year, from a level of 3% in 2006.

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